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ABSTRACT

Over the past 20 years, the share of Kentucky's general fund dollars spent on police and corrections, and health and human services, has increased. Meanwhile, the share spent on elementary and secondary education has not changed, while higher education funding has fallen. Compared to similar states, Kentucky spends less money per student at all levels of the education system, especially in higher education. Among 15 Southern states, Kentucky had the largest decrease in education funding per college student over the last 10 years. The Kentucky Long-Term Policy Research Center projected revenues and expenditures through fiscal year 2004 and found that these trends are expected to continue over the next decade. Overall, Kentucky's revenues will not grow fast enough to maintain the current level of services, if current trends continue. Also, Kentucky's rainy day fund is not well protected. Kentucky should take stronger measures to ensure that the budget reserve fund is adequately funded and protected, continue to search for new ways to cut costs and improve efficiency, ensure that the tax structure provides adequate revenues for state programs, and diligently search for opportunities to improve its investment in the future through education. (Contains two figures depicting projected spending versus revenues from 1994 through 2004, and baseline expenditure projections in six areas.) (TD)

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$5.8 Billion and Change: An Exploration of Long-Term Budgetary Trends

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$5.8 Billion and Change: An Exploration of Long-Term Budgetary Trends

Over the past 20 years, the share of general fund dollars spent on police and corrections, and health and human services, has increased. Meanwhile, the share spent on higher education has fallen. These trends are expected to continue over the next decade. Overall, revenues will not grow fast enough to maintain the current level of services, if current trends continue. Also, the rainy day fund is not well protected. Kentucky should strengthen funding and spending guidelines for the rainy day fund, improve its investment in education, keep the spirit of reform alive, and change the state tax structure.

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Kentucky Long-Term Policy Research Center

Governments at all levels are feeling squeezed between limited resources and seemingly limitless pressures to increase spending, but it was not always this way. Just 30 years ago, when the U.S. economy was robust and expanding, the national debt was much smaller, there were more workers per Social Security recipient, and programs such as Medicare and Medicaid were in their infancy, economists worried about a drag on the economy resulting from public revenues growing faster than public expenditures.[1] In the 1960s, governments had "structural surpluses." Today, governments have "structural deficits."

A structural deficit is not a single-year shortfall, which might occur as the result of an unforeseen natural disaster, a new mandate from the federal government, or a sluggish economy. Rather, a structural deficit is a long-term crisis; it occurs when revenues are projected to consistently grow more slowly than expenditures over several years. Because many states cannot actually run a deficit, certain expenditures may be neglected, sometimes for years, in order to balance the books.

Does Kentucky have a structural deficit? Will the current revenue structure (consisting of various taxes, fees, investments, and governmental transfers) be able to support the current level of services in coming years, or will spending cutbacks be necessary in order to maintain a balanced budget? This report suggests that Kentucky does, in fact, have a structural deficit.

Our claim is based on projected revenues and expenditures through fiscal year (FY) 2004. The revenue projection simply assumes that, without any major changes to the tax structure, general fund revenues will grow at the same rate as personal income—a rather generous assumption given recent growth rates and tax cuts. But this report focuses on expenditures and the possible impact that a variety of trends may have on state spending during the next decade. Of course, no one knows for sure how fast technology will improve or whether the poverty rate will increase or decrease. We cannot be certain that managed care will yield the expected savings for Kentucky's Medicaid system or that the prison population will continue to grow as rapidly as it has in the past. But we can make reasonable assumptions about how these things might change, and how they might affect expenditures.

On the other hand, we assume the quality of state services *will not* change. In other words, the state will not add new restrictions on Medicaid coverage, it will not increase or decrease police protection, it will continue to give its children as good an education as they receive today, etc. We are essentially asking, "With the changes taking place in society, the economy and the populace,

[1] Giertz, J. F., McGuire, T., & Nowlan, J. (1995). *The Illinois structural deficit dilemma: the growing gap between state expenditures and revenue realities.* Champaign-Urbana, IL: University of Illinois, Institute of Government and Public Affairs.

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how much money will Kentucky need to spend 10 years from now in order to give its citizens the same quality of services they receive today?" The answer is, "More money than we'll have."

Future Revenues and Expenditures

We project expenditures to grow approximately 6 percent a year through FY2004, compared to 5.3 percent annual growth for revenues. The difference may not seem like much, but at this rate, expenditures would grow 79 percent between FY1994 and FY2004, while revenues would only grow 67 percent. Even starting with a surplus in FY1994, we project that expenditures will exceed revenues by more than 4 percent in FY2004. This deficit will exist only in theory because in practice spending will have to be less than revenue.

Overall, general fund spending is growing faster than general fund revenue, but not all expenditures are increasing at the same pace. If we divide state spending into functional categories—primary and secondary education, higher education, police and corrections, health and human services, highways and all other—we find that Kentucky's investment in education is growing slower than spending on prisons and health care:

- In our projections, health and human services spending experiences the sharpest increase. We project this function's share of general fund revenues to rise from 18.3 percent in FY1994 to more than 25 percent in FY2004.
- Police and corrections spending rises from 5.3 percent of general fund revenues to more than 6.5 percent.
- Primary and secondary education spending as a percentage of general fund revenues is essentially unchanged.
- Higher education's share of general fund revenues falls from 14.5 percent in FY1994 to less than 13 percent in FY2004.
- Highway spending is financed by the transportation fund, not the general fund, and so is not included in the forecast. But transportation fund revenue is nearly stagnant and real spending is less than it was 20 years ago.
- All other spending slips from 12.6 to 12.1 percent of general fund revenues.

FIGURE 27.1
A Structural Deficit: Spending Outgrows Revenues

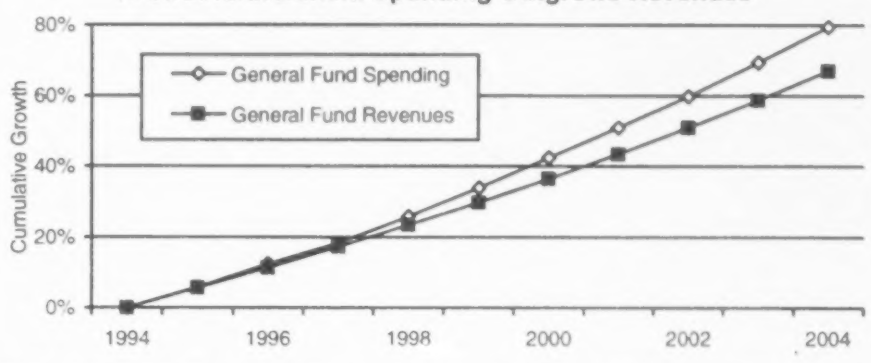
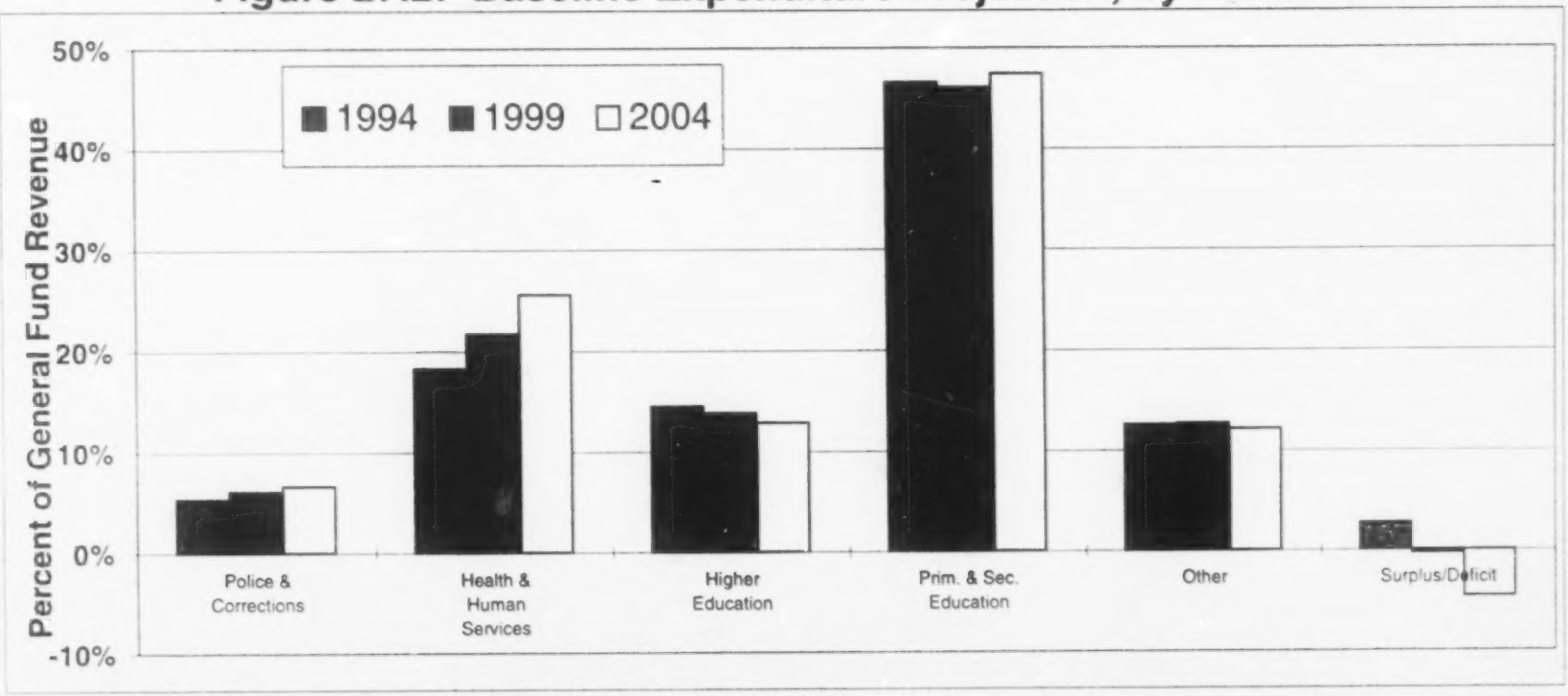


Figure 27.2: Baseline Expenditure Projection, by Function



Source: Kentucky Long-Term Policy Research Center

	Police & Corrections	Health & Human Services	Higher Education	Prim. & Sec. Education	Other	Surplus or Deficit
1994	5.3%	18.3%	14.5%	46.5%	12.6%	2.7%
1999	6.1%	21.7%	13.8%	46.1%	12.7%	-0.4%
2004	6.6%	25.6%	12.9%	47.4%	12.1%	-4.6%

Of course, a healthy populace and a safe society are essentials of a high standard of living. Yet we contend that the best (not to say the only) way to cultivate a high standard of living for future generations is by increasing Kentuckians' knowledge, abilities and talents—the paramount goal of the education system.

Our baseline projection of general fund spending for different functions of government is illustrated on the preceding page. Note the general fund "deficit" of 4.6 percent in FY2004. We are not actually forecasting that Kentucky will have a deficit because it is prohibited by law. Rather, this shows that spending is growing at an unsustainable rate, given the current tax structure and our assumptions about a variety of factors.

Alternative Scenarios

We have already noted that the revenue and expenditure projections assume that the tax and spending structures will not change in the coming years. But what if we were to make a change? What if, for example, Kentucky decides that its spending for education is too low compared to other states and should be increased? Or what if the federal government changes its Medicaid funding policy? Our budget model allows us to change a variety of factors which can create alternative budget scenarios. In this chapter, we explore four alternatives to our baseline forecast:

- An expanded commitment to higher education
- An expanded commitment to primary and secondary education
- A change in federal Medicaid spending
- A recession

The budget projections based on these alternative scenarios do not pinpoint the exact amounts by which expenditures or revenues will change. Rather, they illustrate the magnitude of the impact these events *might* have on the budget.

The "expanded commitment to higher education" scenario includes a gradual increase in both spending per student and college enrollments to meet the regional averages by FY2004. Our analysis suggests that spending for higher education would grow nearly 90 percent between FY1994 and FY2004, compared to a 50 percent increase in the baseline projection. The total additional cost of the expanded commitment to higher education could be more than $1 billion over 10 years. If spending for other functions is unchanged from the baseline levels, higher education spending could exceed 16 percent of general fund revenues, and total spending for all categories would then exceed revenues by more than 8 percent.

In the "expanded commitment to primary and secondary education" scenario, we look at the cost of raising state and local expenditures per pupil to match the regional median. Even assuming local governments bear their share of the increase, we project a huge additional cost—$1.8 billion cumulative—and a deficit of more than 9 percent of general fund revenues in FY2004. In this scenario, spending for primary and secondary education is projected to grow 87 percent between FY1994 and FY2004, compared to a baseline increase of 70 percent.

One of the most contentious items of the federal budget debates of 1995 was Medicaid. Congress considered a variety of proposals to reduce federal spending over several years. One bill would have given Kentucky about $13.3 billion for Medicaid between FY1996 and FY2002. The Urban Institute in Washington projected that this plan would have cut Kentucky's federal Medicaid revenues by about $4.3 billion between FY1996 and FY2002; Kentucky's Cabinet for Health Services projected a reduction totaling about $3.4 billion. Our estimate is that the state would lose roughly $700 million by FY2002 and $2 billion by FY2004. The Urban Institute and the Cabinet for Health Services project gloomier scenarios than we do (because of different assumptions about baseline spending), but even using our estimates, the state could have a general fund deficit of nearly 14 percent by FY2004, and health and human services spending

could amount to more than one-third of all general fund revenue, if we are to maintain the quality of services in the Medicaid program.

We look at a recession scenario to demonstrate the importance of the rainy day fund. This fund supports state spending in lean years when slow economic growth leads to slow revenue growth. While our analysis projects expenditure growth to increase slightly during a recession (we chose 2002 as the year for the recession), it also projects revenue growth to slow to only about 1 percent, compared to 5 percent growth in the baseline forecast. Instead of a baseline deficit of 3 percent in FY2002, the slow revenue growth could create a deficit of more than 5 percent.

Recommendations

Many trends are largely outside the province of policymaking, particularly at the state level. If Kentucky is to maintain—let alone improve—the quality of services it currently provides, it must be proactive in managing the trends affecting spending. The state must develop and adopt strategies for strengthening its financial outlook in years to come. We offer four recommendations:

- Take stronger measures to ensure that the budget reserve fund is adequately funded and adequately protected.
- Keep alive the spirit of the Governor's Commission on Quality and Efficiency by searching for new ways to cut costs and improve efficiency.
- Be diligent in finding opportunities to improve our investment in the future through education.
- Ensure that our tax structure provides adequate revenues for state programs.

Strengthen the Budget Reserve Fund. The current provisions for funding Kentucky's budget reserve fund are rather weak; the reserves cannot exceed 5 percent of actual general fund receipts, and any deposits made to the fund out of excess revenues are made after the state implements its surplus expenditure plan, if it so chooses. Protection of the reserve fund is even weaker—reserve funds may be appropriated at any time by the General Assembly. It's like saving money by putting it into your wallet instead of the bank. In the absence of a sound budget reserve fund, the budget effects of a recession could be brutal.

Keep Reform Alive. In its 1994 report, the Governor's Commission on Quality and Efficiency examined past budgets and noted that Kentucky has suffered budget shortfalls in 9 of the last 12 budget cycles and 4 of the last 7 years. In our report, we predict that budget shortfalls will continue to be a way of life, funds will not be available to make an expanded commitment to education, and a recession or a change in federal Medicaid policy would require severe spending cuts. Whether the Commission studies the past or we gaze into the future, the conclusion is the same: in the words of Jim Gray, chairman of the Commission, "We must change the way we manage our government."

Improve and Invest in Education. Perhaps nowhere is innovation and increased efficiency more urgent than in education. Compared to similar states, Kentucky spends less money per student at all levels of the education system. And while we are closing the spending gap at the primary and secondary level, the gap in higher education spending is widening. The Southern Regional Education Board reports that among 15 Southern states, Kentucky had the largest decrease in education funding per college student over the last 10 years. We estimate that Kentucky would have to spend an additional $1 billion over the next decade just to match median spending on higher education by our benchmark states.

While it is beyond the scope of this report to examine possible education reforms in much detail, we will note that various experts have criticized the higher education system in Kentucky for duplication of services, "turf fights," and lack of coordination, all of which decrease efficiency. To increase efficiency, businesses and other private associations might share in the costs and planning of higher education. And clearly, any substantial commitment of new state resources to higher education must be accompanied by closer collaboration among institutions and the different agencies responsible for post-secondary education.

Change the State Tax Structure. As with education reform, we will not offer many specific recommendations on tax policy. Others have done that for us. In a study by University of Kentucky professor William Hoyt, the extensive and detailed work of the Kentucky Commission on Tax Policy, and the analysis of others who have looked at this issue, we have numerous recommendations for changes in the state tax system.[2] (We should note that the Commission on Tax Policy had no authority to enact any of the changes it recommended.) In the absence of tax reform, it seems clear that revenues will not keep pace with expenditures, and state services as they now exist will be compromised. It is highly unlikely that Kentucky will be able to expand its commitment to education (or, for that matter, other kinds of workforce training, economic development or environmental protection) if expenditures and revenues continue along their current paths.

[2] See Hoyt's chapter in this volume, and Kentucky Commission on Tax Policy. (1995). *Final report*. Frankfort, KY: Author.